

Internal Revenue Service memorandum

date: MAR 19 2001

to: Director, Employee Plans Rulings and Agreements
(Tax-Exempt and Government Entities) T:EP:RA
Attn.: Larry Isaacs or Jim Holland

from: Office of Division Counsel / Associate Chief Counsel
(Tax-Exempt and Government Entities) CC:TEGE:EB:EC

subject: Control # FREV-128638-00

This is in reply to your November 29, 2000 request for our technical assistance in addressing Issues (3) and (4) in the referenced ruling request. Please feel free to use the following paragraphs in your reply to the Taxpayer:

Legend:

Plan =

Pension Plan =

Trust Agreement =

Trust =

Trustees =

The information submitted states that the Plan is intended to be a defined contribution excess benefit plan that will provide supplemental retirement benefits to selected employees of employers ("Employers") who participate in the Pension Plan (a qualified defined benefit plan). The Trust, which has been established for the exclusive benefit of employees participating in the Plan and their beneficiaries, is not a trust described in section 401(a) of the Internal Revenue Code, nor is it exempt from tax under section 501(a).

The only participants in the Plan are employees who are already receiving retirement benefits under the Pension Plan. All participants in the Plan are fully vested in the benefits payable to them under the Plan.

Two types of benefits are payable annually from the Trust. First, a participant will receive a "Section 415 Reduction" benefit ("Excess Benefit"), which is the amount by which the participant's retirement benefit otherwise payable to him (or her) under the Pension Plan for the *prior* calendar year was reduced to satisfy the requirements of section 415 of the Code. Second, the participant will be paid an amount equal to his share of the FICA taxes due with respect to his Excess Benefit. Separate accounts are maintained for each participant. All benefits payable for a Plan year will be paid before the end of that year or as soon thereafter as is administratively feasible.

The Employers' contributions to the Trust will be irrevocable, except to the extent that they were made as a result of a mistake of law or fact. No part of the Trust's principal or income may revert to any of the Employers or be used for any purpose other than providing the benefits specified in the Plan. Amounts held in the Trust are not subject to the claims of the Employers' creditors, and it is explicitly provided that all right, title, and interest in and to the assets of the Trust are at all times vested exclusively in the Trustees.

If, in connection with the performance of services, property is transferred to anyone other than the service recipient, the excess of the fair market value of the property over the amount paid for the property is included in the service provider's gross income for the first taxable year in which the rights to the property are either transferable or not subject to a substantial risk of forfeiture. See section 83(a) of the Code.

For purposes of section 83 of the Code, the term "property" includes real and personal property other than money or an unfunded and unsecured promise to pay money or property in the future. The term also includes a beneficial interest in assets (including money) transferred or set aside from the claims of the transferor's creditors, for example, in a trust or escrow account. See section 1.83-3(e) of the Income Tax Regulations.

If a transfer of property is subject to the rules of section 402(b) of the Code, section 83 applies to the transfer only as provided for in section 402(b). See section 1.83-8(a)(4) of the regulations. Section 402(b) applies to transfers of property for the benefit of employees or their beneficiaries to an employees' trust, unless the trust is exempt from tax under section 501(a). See section 402(b).

Under the terms of the Plan and the Trust Agreement, the Employers will make irrevocable contributions to the Trust for the exclusive purpose of providing benefits under the Plan to participating employees and their beneficiaries. The Trust's assets are not subject to the claims of the Employers' creditors, and the Trust is not exempt from tax under section 501(a) of the Code. Accordingly, the rules of section 402(b) govern the taxation of the Employer contributions to the Trust to the employees.

Under section 402(b)(1) of the Code, an employer's contributions to an employees' trust that is not exempt from tax under section 501(a) are included in the employee's gross income in accordance with section 83. However, the value of the employee's interest in the trust is substituted for the fair market value of the property when applying section 83. Such contributions are included as compensation in the employee's gross income for the taxable year of contribution to the extent that the employee's interest therein is "substantially vested" when the contribution is made. See sections 1.402(b)-1(a)(1) and 1.83-3(b) of the regulations.

However, if one of the reasons that a trust is not exempt from tax under section 501(a) of the Code is the failure of the plan of which it is a part to meet the requirements of section 401(a)(26) or section 410(b), then, instead of including in gross income the amount computed under section 402(b)(1), a highly compensated employee includes in gross income for his or her taxable year with or within which the trust's taxable year ends an amount equal to the employee's vested accrued benefit (less the employee's investment in the contract) as of the close of the trust's taxable year. See section 402(b)(4)(A). For this purpose, the term "highly compensated employee" is defined in section 414(q). See section 402(b)(4)(C).

Accordingly, in response to ruling request (3), if you determine that the Plan fails to meet the requirements of sections 401(a)(26) or 410(b) of the Code, we conclude that section 402(b)(4)(A) will apply to highly compensated employees participating in the Plan, and section 402(b)(1) will apply to all other participants.

Therefore, a highly compensated employee participating in the Plan will include in gross income, for each taxable year with or within which a taxable year of the Trust ends, an amount equal to the employee's vested accrued benefit (less his investment in the contract) under the Trust as of the close of the Trust's taxable year. For this purpose, an employee's vested accrued benefit equals the lesser of his Trust account balance or the present value of his vested accrued benefit under the Plan. The employee's vested accrued benefit under the Plan includes both the employee's vested accrued Excess Benefit and his right to receive payment of the employee portion of the FICA tax due with respect to that benefit.

Amounts actually distributed or made available by the Trust to participating employees will be taxed to them, under the rules of section 72 of the Code, in the year in which distributed or made available to them. See section 402(b)(1). When applying those rules, distributions of trust income before the "annuity starting date," as defined in section 72(c)(4), are included in the recipient's gross income without regard to section 72(e)(5) (relating to amounts not received as annuities).

The Plan is a plan deferring the receipt of compensation. See Q&A-2 of section 1.404(b)-1T of the temporary Income Tax Regulations. Section 404(a) of the Code provides that compensation paid or accrued by an employer on account of any employee under such a plan is not deductible under Chapter 1 of the Code, but, if it would otherwise be deductible, is deductible under section 404, subject to the limitations that section.


Under section 404(a)(5) of the Code, an employer contribution made under a nonqualified deferred compensation plan is deductible by the employer in the taxable year in which an amount attributable to the contribution is includible in the gross income of an employee participating in the plan. However, if more than one employee participates, the deduction is allowed only if separate accounts are maintained for each participating employee.

Section 1.404(a)-12(b)(1) of the regulations clarifies that, to the extent allowable under section 404(a) of the Code, a deduction is allowed for employer contributions under a nonqualified deferred compensation plan only in the taxable year of the employer in which or with which ends an employee's taxable year in which an amount attributable to the contributions is includible in the employee's gross income as compensation.

The regulation provides an example in which an employer contributes \$1,000 to the account of its employee during the employer's taxable (calendar) year 1977. The amount in the account attributable to the contribution is not includible in the employee's gross income until the employee's taxable (calendar) year 1980, at which time the includible amount is \$1,150. The example concludes that, if it would otherwise be allowable under section 404(a) of the Code, the employer's deduction for the contribution is limited to \$1,000 in 1980. In effect, an employer receives no deduction under section 404 for the amount includible in an employee's gross income to the extent that such amount exceeds the amount actually contributed by the employer.

Accordingly, in response to ruling request (4), we conclude that contributions to the Trust made by Employers for the benefit of their employees are deductible by the contributing Employer only under the rules of section 404 of the Code and only for the contributing Employer's taxable year in which or with which ends the employee's taxable year in which an amount attributable to the contributions is includible in his

gross income as compensation. Additionally, we specifically note that such deductions will be allowed only if the "separate accounts" requirement of section 404(a)(5) of the Code and section 1.404(a)-12(b)(3) of the regulations is satisfied. In this regard, we express no opinion as to whether that requirement is, or will be, satisfied. When applying the above rules, Trust income is not treated as an employer contribution to the Trust and is, therefore, not deductible by the Employers.



We hope that this assistance will be helpful to you. If you have any questions, please feel free to call